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UNCLAS SECTION 01 OF 03 COLOMBO 000527

SIPDIS

SENSITIVE

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SUBJECT: SRI LANKA: GOVERNMENT RAISES FUEL PRICES BY RECORD AMOUNTS
TO STEM SUBSIDY LOSSES; PROTESTS NOT YET A THREAT

REF: A. COLOMBO 503 B. COLOMBO 428 C. COLOMBO 76

11. (SBU) Summary and comment: On May 25, the Ceylon Petroleum Corporation, Sri Lanka's state-owned oil company, raised diesel and gasoline prices by an unprecedented 37% and 23% respectively. This is the second CPC fuel price increase in 2008, bringing prices to double the level of two years ago. The price increases were necessary to stem the CPC's losses from selling fuel below its cost, which would otherwise add to the government's budget deficit. The fuel price hike was immediately followed by increases in bus and train fares, and will ripple through other economic activities that involve transportation, exacerbating Sri Lanka's 25% inflation rate. The government's proposed solutions to the rising cost of living -- a mix of price controls, more subsidies, and talk of conservation -- are unlikely to be effective. The opposition and unions have organized minor protests against the government over the cost of living, but at this point these do not have the numbers or urgency to threaten the government. End summary and comment.

FUEL PRICES UP BY RECORD AMOUNT TO REVERSE HIGH LOSSES

12. (U) The Ceylon Petroleum Corporation (CPC) raised its retail gasoline and diesel prices by 30 Rupees per liter on May 25. The new price of standard gasoline following the 23% increase is Rs 157 per liter (about \$5.50 per U.S. gallon). The new price of standard auto diesel is Rs 110 per liter (about \$3.85 per gallon), an increase of 37%. The CPC also increased the price of kerosene, used by low income householders for cooking, by Rs 10 to Rs 80 (\$0.74) per liter. The CPC is a large and inefficient state-owned firm that both imports refined oil products and refines crude oil domestically (ref A). Its prices are set by the government, which in turn reimburses it in a complex formula that guarantees the CPC to earn about 2.5% over whatever its costs are. The government's price formula is set to cross subsidize below-cost kerosene and diesel prices with an above-cost gasoline price.

13. (U) This was the CPC's second fuel price increase in 2008 and the largest one-time increase ever. The new prices are double what prices stood at in mid-2006. President Rajapaksa told his cabinet he had authorized the price increases as a result of rising world oil prices, and that the government could no longer continue to incur losses by subsidizing fuel. According to the President, the CPC had lost about \$70 million in the first four months of 2008, as it was losing over Rs 40 (\$0.37) per liter from kerosene and diesel sales. (The CPC Chairman separately put its loss rate at about Rs 60 per liter).

14. (SBU) The Ceylon Petroleum Corporation controls about 75% of the Sri Lankan retail fuel market. The CPC's only competitor is Lanka Indian Oil Company (LIOC), which is free to set its own prices but which normally maximizes profits by setting prices equal to those of CPC. Because it is more efficient than the CPC, it can make profits at price levels at which the CPC incurs losses. Following the CPC price increase, LIOC as usual raised its gasoline price to match that of the CPC; it had raised its diesel prices prior to the CPC move. In the midst of this, the government has also increased taxes on fuel imports. The LIOC told EconFSN it believed the new taxes were being imposed only on LIOC, and that it had raised its diesel prices another 20 Rupees to 130 per liter to compensate. However, the Finance Ministry told us that the new taxes would apply to both CPC and LIOC imports. The government imposes a range of taxes on imported gasoline and diesel, amounting to roughly \$2 per gallon for gasoline -- i.e. over a third of the final retail cost. The taxes on diesel are much lower.

TRANSPORTATION PRICES RISING WITH FUEL PRICES...

15. (U) The hike in fuel prices was followed immediately by a 27% increase in private bus fares. The government-owned Ceylon Transport Board (CTB) raised its bus fares by 17%. In turn, the government will provide a subsidy to CTB to cover the higher cost of fuel. In addition, the government is considering doubling its heavily subsidized rail fares from June 1, in what would be the first rail price hike in three years. Electricity tariffs may also need to be increased. The state-owned and subsidized, but still unprofitable, Ceylon Electricity Board will incur greater losses now

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that the price of furnace oil, used for electricity generation, has been increased by Rs 10 per liter. Electricity tariffs were increased in April 2008 by 50 to 100%, but would need to rise further if the government wanted to stem the Electricity Board's losses.

... ADDING TO ALREADY HIGH INFLATION

16. (U) The fuel price hikes are also likely to exacerbate already high food prices, which have increased by 50% to 100% in the past year (ref B). The soaring prices of essential goods and services have prompted the President to appoint a special cabinet subcommittee headed by the Prime Minister to work out strategies to address the issue of high cost of living.

17. (U) Meanwhile, the Central Bank of Sri Lanka in its May 26 Monetary Policy statement said that actual inflation for 2008 would be significantly higher than the bank's previous estimates due to the surge in international oil prices. The bank had made its initial projection of 10-15% inflation by year end on the basis of expected \$90 per barrel oil (ref C). Inflation as measured by the newly revised Colombo Consumer Price Index was 26% year on year in May 2008.

GOVERNMENT URGES CONSERVATION...

18. (U) The government is hoping the fuel price hike will cause consumers to reduce their fuel consumption. On May 27, President Rajapaksa appealed to the public "to be frugal in consuming fuel to the greatest possible extent to face the current global oil crisis." The Minister of Power and Energy also made a similar appeal to electricity consumers. Treasury Secretary P B Jayasundera told the press on May 26 that even with skyrocketing prices, Sri Lankans had not decreased fuel consumption. Local media reported the cabinet is considering fuel conservation measures such as setting school schedules to four days a week, requiring civil servants to use public transportation one day a week, and reducing the number of meetings government officials hold outside their offices. The government is hoping for a 20-25% reduction in fuel consumption after the present hike. If consumption does not decrease, the government expects Sri Lanka's fuel import bill to rise to \$3.5-\$4

billion in 2008 from \$2.5 billion in 2007.

...WHILE OPPOSITION ORGANIZES PROTESTS

19. (U) On May 27 in Colombo, the main opposition United National Party staged a protest march against the rising fuel prices. Protestors in bullock carts blamed the rising prices on government corruption. The UNP also ridiculed the government for increasing fuel prices despite bragging about obtaining oil at concessionary rates from Iran and other friendly Arab countries. The UNP said that the May 27 rally was the start of a series of protests to be held island-wide to urge the government to provide relief to the people. The Marxist JVP and the JVP breakaway group, the National Freedom Front, are also protesting against the rising cost of living, mismanagement and corruption. They have asked for relief targeted at the poor. A JVP-affiliated trade union has asked the government for a Rs 5,000 monthly salary hike for working people, and vowed to stage island-wide protests and strikes if their demands are not met.

110. (U) To head off protests, the government is discussing with employers' associations minimum wage increases for private sector workers. The government has proposed to increase the current minimum wage in 37 industries coming under the Wages Board Ordinance (WBO). It proposes to increase the minimum wage for unskilled workers from Rs 5,000 (\$46) to Rs 5,750 (\$53) per month. Minimum wages for several other categories of workers in the 37 industries would be increased through the wages board mechanism. Employers and employees have been given until June 13 to file objections to the proposed increase. Government workers, who account for about a fifth of the workforce, received wage increases of about 56% between 2005 and 2007.

COMMENT: HIGH INFLATION HEADED HIGHER;

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PROTESTS STILL NOT THREATENING GOVERNMENT

111. (SBU) The fuel, transport, food, and impending wage hikes will only add to Sri Lanka's already high 25% inflation. The government cannot relish having to defend itself against criticism that it is not doing enough to help the poor manage the rising cost of living, but has emphasized that global price increases -- especially those of oil and food -- are at fault, not its own management of the economy. In fact, the Rajapaksa administration deserves a good deal of the blame, as it has only added to the money losing ways of the many inefficient state-owned corporations and the overall cost of the bloated government with its 100-plus ministers and tens of thousands of new civil servants. These, and the intensified war against the Liberation Tigers of Tamil Eelam, are responsible for the high budget deficits that have fueled inflation.

112. (SBU) The government clearly is taking seriously the political implications of citizens unhappy with the rising cost of living. However, its proposed solutions -- a mix of price controls, more subsidies, and talk of conservation -- are unlikely to be effective in controlling inflation. Nevertheless, it appears for now that street protests and threatened union action pose no real danger to the government's survival, as there is not yet a sense of urgency or outrage in the air. This is probably a result of the Sri Lankan public's generally passive reaction to bad governance and its willingness to accept hardship -- as long as it believes the government is winning the war against the LTTE. Moreover, the President's core voter constituency, in rural areas of Southern Sri Lanka, is relatively insulated from fuel and other price hikes because they grow their own food, travel little, and are sufficiently poor to qualify for subsidized electricity rates. Hardest hit are urban dwellers, whom Rajapaksa is less concerned about because he assumes most already support the opposition UNP.

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